Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:TL-N-4844-99
[redacted]

date: JUL 28 2000

to: Manager, Examination Group [redacted]
Attn: [redacted], Revenue Agent

from: District Counsel, [redacted] District, [redacted]

subject: [redacted]
Regulatory Intangibles

This memorandum is in response to your request for our assistance with regard to the above subject. This advice is subject to post review by our National Office and should not be relied upon for a period of 30 days.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to the attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether [redacted]'s "supervisory goodwill" qualifies as "money or other property" for purposes of I.R.C. § 597.

2. Whether [redacted] may properly claim losses under I.R.C. § 165 for amounts attributable to "supervisory goodwill."

CONCLUSIONS

1. Supervisory goodwill is not financial assistance received from the Federal Savings and Loan Insurance Corporation under section 406(f) of the National Housing Act, 12 U.S.C. § 1729(f) and thus, does not qualify as money or other property for purposes of I.R.C. § 597.

2. [redacted] may not claim losses under I.R.C. § 165 for amounts attributable to supervisory goodwill.

FACTS

The facts are condensed[1] from the Notice of Proposed Adjustment, Form 5701; responses to Information Document Requests, IDRs, numbers 003 through 005; and explanation attached to the Amended U.S. Corporation Income Tax Return, Form 1120X, you forwarded to our office. All of these documents are attached.

In [redacted], an Illinois-chartered savings and loan holding company, acquired [redacted]. At the time of the acquisition, [redacted] was financially insolvent, with liabilities exceeding assets by a significant margin. [redacted] was then merged into [redacted] and the merger treated as a tax-free reorganization pursuant to I.R.C. § 368(a)(1)(G). For financial accounting purposes, the acquisition was accounted for pursuant to the purchase method of accounting.

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[1] Since the facts are fully set forth in the Notice of Proposed Adjustment, Form 5701, and its attached Explanation of Items, Form 886, they will not be reproduced herein.

The acquisition of [redacted] by [redacted] was allegedly made for "supervisory reasons", with assistance being provided by the Federal Savings and Loan Insurance Corporation, (FSLIC). The assistance provided by FSLIC allegedly included a regulatory intangible asset allowing [redacted] to include such asset when calculating its regulatory capital ratios for a period of [redacted] years. [redacted] determined the value of the regulatory intangible to be $[redacted], and included it on its financial statements as "goodwill." The regulatory intangible was excluded from gross income by [redacted] pursuant to I.R.C. § 597. [redacted], however, recognized this goodwill in calculating its regulatory capital ratios, and asserted that it acquired a tax basis therein equal to the fair market value of the goodwill as of the date it was acquired.

In August of 1989, Congress enacted the Financial Institution Reform, Recovery and Enforcement Act of 1989, (FIRREA), which phased-out, over a five year period, the right to count the regulatory intangible for purposes of calculating the regulatory capital ratios.

In [redacted], acquired all of the outstanding common stock of [redacted] and its subsidiaries, including [redacted]. [redacted] was then merged into [redacted] and the merger treated as a tax-free reorganization pursuant to I.R.C. § 368(a)(1)(D).

As a result of FIRREA, [redacted] took the position the regulatory intangible became completely worthless and was abandoned as of [redacted]. [redacted] asserted that FSLIC guaranteed [redacted] it could count goodwill towards its capital reserve requirements, and such guarantee was a form of assistance contemplated by section 406(f) of the National housing Act, 12 U.S.C. § 1729(f). This assistance, [redacted] further asserted, was a valuable right constituting "property" within the meaning of I.R.C. § 597.

Accordingly, on [redacted], [redacted] filed an amended return, Form 1120X, claiming a refund in the amount of $[redacted], as a result of the loss on the abandonment of the regulatory intangible.

DISCUSSION AND ANALYSIS[2]

Issues 1:

A. I.R.C. § 597

Internal Revenue Code section 597 was added to the Code effective January 1, 1981. This section was intended to resolve the question of whether financial assistance from the FSLIC was either includible in income because of a quid pro quo, or whether the assistance was a non- shareholder contribution to capital within the meaning of *United States v. Chicago, B&Q RR. Co.*, 412 U.S. 401 (1973), and would have a zero basis itself under section 362(c) or reduce the basis of other property owned by the taxpayer. H.R. Conf. Rep. No. 97-215, 97th Cong., 1st Sess. 284 (1981).

Section 597 applied solely to assistance furnished by the FSLIC. Moreover, it applied solely to FINANCIAL assistance authorized by section 406(f) of the National Housing Act, 12 U.S.C. § 1729(f). The legislative history underscores the application of section 597 solely to financial assistance. Specifically, the Conference Report states:

> The bill excludes from income of a building and loan association all money or property contributed to the thrift situation by the Federal Savings and Loan Insurance Corporation under its financial assistance program without reduction in basis of property. The amendment applies to assistance payments whether or not the association issues either a debt or equity instrument in exchange therefore.

H.R. Conf. Rep. No. 97-215, 97th Cong., 1st Sess. 284 (1981).

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[2] Our analysis is adopted from Field Service Advice (FSA) 200013006, issued December 29, 1999. The facts in this case, except for the claim filed in the Winstar litigation, are identical to those in the FSA and, accordingly, the same analysis should apply. While we recognize an FSA is not precedential, through coordination with the National Office and the Commercial Banking ISP, it is our understanding the FSA, and its supplement, FSA 200028001 issued on March 22, 2000, reflect the current position of the Office of Chief Counsel on this issue.

Similarly, in the House of Representative's Ways and Means Committee report accompanying FIRREA, the report describes prior law as providing:

> Payments from the Federal Savings and Loan Insurance Corporation . . . to a financially troubled financial institution are not included in the income of the recipient institution and such institutions need not reduce their basis in property by the amount of such financial assistance. . . . (Code sec. 597).

H.R. Rep. No. 101-54, 101st Cong., 1st Sess., pt. 2, at 24 (1989).

B. FSLIC and section 406(f) of the National Housing Act

The FSLIC was created pursuant to Title 12 U.S.C. section 1725. The statute referred to formation and operation of the FSLIC under the direction of the Federal Home Loan Bank Board (FHLBB) for the purpose of providing insurance for savings and loan accounts. In addition to providing deposit insurance, the FSLIC was authorized to provide assistance from its assets to insolvent savings associations. This assistance included capital contributions, deposits, asset purchases, assumption of liabilities and loans. National Housing Act section 406(f), 12 U.S.C. § 1729(f) (1982). The FSLIC was abolished by FIRREA, and its functions were transferred to the Federal Deposit Insurance Corporation and the Resolution Trust Corporation.

C. The Savings and Loan Crisis and the *Winstar* litigation

As discussed more fully in *United States v. Winstar Corp.*, 518 U.S. 839 (1996), during the years in issue, the savings and loan industry was in crisis, and the FSLIC lacked the funds necessary to liquidate all of the failing thrifts. Accordingly, the FSLIC arranged mergers between healthy thrifts and failing thrifts. As an inducement for these mergers, the FSLIC allowed the acquiring thrifts to count supervisory goodwill toward regulatory capital reserve requirements set forth in 12 C.F.R. section 563.13, and to amortize the goodwill for a period of 40 years. In 1989, Congress enacted FIRREA which impacted a thrift's ability to count supervisory goodwill towards satisfaction of its capital reserve requirements. After many

lower court battles, the issue finally reached the Supreme Court in *Winstar*. In that case, the Supreme Court held the thrifts had an enforceable contract with the FHLBB and the FSLIC, and the Government breached that contract as a result of the enactment of FIRREA.

D. Analysis

In 1981 section 597(a) of the Code applied solely to financial assistance authorized by section 406(f) of the National Housing Act. The supervisory goodwill at issue here does not rise to the level of FSLIC financial assistance, as it is not listed in section 406(f) of the National Housing Act. Furthermore, supervisory goodwill does not resemble any type of financial assistance listed in section 406(f), e.g. capital contributions, deposits, asset purchases, assumption of liabilities and loans. The types of transactions listed in section 406(f) imply that something of value, either cash or an asset, changes hands between the FSLIC and the acquiring thrift. With respect to supervisory goodwill, no money or assets are received by the thrift from the FSLIC. Rather, the concept of supervisory goodwill was merely part of an accounting regime designed to induce healthy thrifts to acquire failing thrifts. In *Winstar*, the Supreme Court acknowledged that because the FSLIC had insufficient funds to make up the difference between a failed thrift's liabilities and assets, the Bank Board had to offer a "cash substitute" to induce a healthy thrift to assume a failed thrift's obligations. *Id.* at 849-50.

The Congressional Record accompanying FIRREA further underscores the conclusion that supervisory goodwill was only an accounting gimmick, rather than actual financial assistance. In 1989, Representative Kleczka remarked that "goodwill is not cash. It is a concept, and a shadowy one at that. When the Federal Government liquidates a failed thrift, goodwill is simply no good. It is valueless." 135 Cong. Reg. 11795 (1989).

Pursuant to all the above, we conclude supervisory goodwill does not qualify as money or other property for purposes of section 597.

Issue 2 :

A. I.R.C. § 165

Internal Revenue Code section 165 allows as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Only a bona fide loss is allowable, and substance, not mere form, governs the determination of whether a loss is deductible. Treas. Reg. § 1.165-1(b).

The requirements for an abandonment loss are found in the regulations under section 165. Specifically, Treas. Reg. § 1.165-2(a) allows a loss incurred in a business and arising from the sudden termination of the usefulness of any nondepreciable property, in a case where the business is discontinued or where the property is permanently discarded from use therein, as a deduction under section 165(a) for the taxable year in which the loss is actually sustained.

Treasury Regulations section 1.165-1(b) requires that, to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, and fixed by identifiable events. *See United States v. S.S. White Dental Manufacturing Co.*, 274 U.S. 398, 401 (1927). Normally, an abandonment loss requires (1) an intention on the part of the owner to abandon the asset, and (2) an affirmative act of abandonment. *A.J. Industries, Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974); *CRST, Inc. v. Commissioner*, 92 T.C. 1249, 1257 (1989), aff'd, 909 F.2d 1146 (8th Cir. 1990).

B. Basis

Pursuant to Treas. Reg. § 1.165-1(c)(1), the amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by Treas. Reg. § 1011-1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved. Thus, in the case of each such deduction claimed, the basis of the property must be properly adjusted as prescribed by Treas. Reg. § 1.1011-1. As provided in Treas. Reg. § 1.1001-1, the adjusted basis for determining the gain or loss from the disposition of property is the cost or other basis prescribed in section 1012 or other applicable provisions of subtitle A of the Code.

Supervisory goodwill is the excess of the purchase price (which included liabilities assumed by the acquirer) over the fair market value of the assets acquired from the failing thrift. It is likely that most of the supervisory goodwill was derived from devalued loans that had declined in value because of rising

interest rates. *See Winstar*, 518 U.S. at 851-52. [redacted]'s, and subsequently [redacted]'s, tax basis was properly in the loans and other assets from which the supervisory goodwill was derived and not in the supervisory goodwill itself.

. In this case, [redacted] argues that the right to count supervisory goodwill toward regulatory capital requirements constituted "FSLIC assistance." [redacted] also asserts that the right to use the purchase method of accounting and resulting supervisory goodwill as substitute capital was a valuable right and assistance, albeit not monetary assistance, from the FSLIC.

Absent special circumstances, a taxpayer would have to have gross income result from the receipt of property for that property to obtain a basis derived from the property's fair market value. To explain, the receipt of property can be income to a taxpayer and the amount of income is the property's fair market value. Treas. Reg. § 1.61.-2(d); *Strong v. Commissioner*, 91 T.C. 627 (1988). The taxpayer's basis in the property is then equal to the amount taken into income, that is, its fair market value. *Strong*, 91 T.C. at 639; *Stahl v. Commissioner*, T.C. Memo. 1987-323. Thus, in circumstances like the present case, if the receipt of property does not result in income, no basis is created. Rev. Rul. 92-16, 1992-16 C.B. 15.

[redacted]'s argument rests in part on the special provisions of former section 597 of the Code, under which assistance payments were excluded from gross income but also did not reduce basis. As discussed more fully above, we conclude supervisory goodwill does not qualify for the exclusion under section 597 of the Code. However, assuming for purposes of discussion I.R.C. § 597 applies in this case, we conclude that to derive a fair market value basis from the FSLIC assistance, [redacted] must have gross income, or at least what would otherwise be gross income, absent the application of former section 597. However, even absent the exclusion under former section 597, the FSLIC's agreement to allow [redacted] to use supervisory goodwill toward regulatory capital requirements would not be income to [redacted] no matter how valuable the right.

The creation of property rights under an assortment of government regulatory and licensing arrangements has been found not to result in gross income to the recipient of the rights. See GCM 39,606 (Feb. 27, 1987). This position is succinctly demonstrated in Rev. Rul. 92-16, which holds that the issuance of emission allowance by the Environment Protection Agency does not result in gross income to the utility that receives it. Accordingly, under section 1012, a utility's basis in the allowances is not measured by reference to their fair market

value. An emission allowance permits the emission of more pollutants and, thus, like the present case, is not a financial payment. Similarly, Rev. Rul. 67-135, 1967-1 C.B. 20, holds that the excess, if any, of the fair market value over the cost of an oil and gas lease obtained by a taxpayer in a lottery conducted by the United States Bureau of Land Management is not includible in gross income of the taxpayer recipient.

The above position is implicitly supported by court cases holding that the taxpayer's basis in similar property rights obtained from the government is simply the cost of obtaining rights. *See, e.g., Nachman v. Commissioner*, 191 F.2d 934 (5th Cir. 1951); *Nicolazzi v. Commissioner*, 79 T.C. 109 (1982), *aff'd per curiam*, 722 F.2d 324 (6th Cir. 1983); *Radio Station WBIR v. Commissioner*, 31 T.C. 803 (1959). Because these cases do not include the fair market value of the property received in basis, they assume that no income was imputed from the receipt of the property.

The present case involves facts that are even less likely to result in income than the normal governmental granting of rights because the present case involves a clear quid pro quo. Thus, even if the right involved in the present case was not obtained from the government, it would not be gross income because entering an advantageous agreement does not in the usual case create income to a taxpayer. For example, the purchase of property for less than its fair market does not normally result in income to the purchaser. *Palmer v. Commissioner*, 302 U.S. 63, 68-69 (1937); *Elverson Corporation v. Helvering*, 122 F.2d 295, 297 (2d Cir. 1941); *Hunt v. Commissioner*, 90 T.C. 1289, 1304-05 (1988). Even more basically, Corporation has not shown that the assistance agreement represented anything but an arms length agreement under which both parties provided equivalent consideration. Thus, arguably there was no income because there were no "accessions to wealth" as required by *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

C. Amount of the Loss

Even if [redacted] was allowed to have some loss based on fair market value of the right received, the fair market value of the loss would not approach the full amount of the supervisory goodwill. [redacted] did not lose an amount equal to the supervisory goodwill, but only the right to use the supervisory goodwill toward regulatory capital requirements. This is made clear in a case determining the damages to another plaintiff in the *Winstar* litigation, which stated:

> Plaintiff argues that its loss of goodwill as capital was a cost for which it should be reimbursed. However, goodwill is not a cost that should be reimbursed dollar for dollar. [Plaintiff] quantified goodwill on its books and used that number to meet its capital requirements. While goodwill was used as capital for those purposes, it is not equivalent to capital and does not have a dollar for dollar value.

California Federal Bank v. United States, 43 Fed. Cl. 445, 449 (1999), *appeal docketed*, 99-5108 and 99-5119 (Fed. Cir. June 14 & 28, 1999).

In addition, based on the Form 1120X filed by [redacted], it appears the majority[3] of the basis in the supervisory goodwill is being deducted in [redacted], presumably the last year of the 5 year phase-out period permitted by FIRREA. However, since FIRREA allowed the goodwill to be phased-out over 5 years, [redacted], or [redacted] at the time, should have, at a minimum, been ratably taking deductions for the goodwill over the 5 year period. Accordingly, if it is determined that a loss is allowed, the amount of the loss is well below the $[redacted] shown on the Form 1120X

D. Abandonment of Intangible Assets

It is clear that intangible assets may be the subject of an abandonment loss. *Parmelee Transportation Co. v. United States*, 351 F.2d 619 (Ct. Cl. 1965). *See Massey-Ferguson, Inc. v. Commissioner*, 59 T.C. 220 (1959), acq. 1973-2 C.B. 2; *Solar Nitrogen Chemicals, Inc. v. Commissioner*, T.C. Memo. 1978-486.

The present case involves an intangible that has been characterized by the Supreme Court as goodwill. *See Winstar*, 518 U.S. at 848-49. Normally, goodwill may not be abandoned until the business to which it relates ceases to operate. *Thrifticheck Service Corp. v. Commissioner*, 33 T.C. 1038 (1960), *aff'd*, 287

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[3]Based on the statement attached to the Form 1120X, a fair market value of $[redacted] was determined for the goodwill at the time of [redacted]'s acquisition of [redacted]. The Form 1120X, however, reflects a deduction in the amount of $[redacted].

F.2d 1 (2d Cir. 1961); *Illinois Cereal Mills, Inc. v. Commissioner*, T.C. Memo. 1983-469, aff'd, 789 F.2d 1234 (7th Cir.), *cert. denied*, 479 U.S. 995 (1986); *Danco Products, Inc. v. Commissioner*, T.C. Memo. 1962-52. Otherwise, the transaction is not considered to be a closed and completed transaction within the meaning of Reg. section 1.165-1(b). *Illinois Cereal Mills*.

Exceptions arise when the taxpayer abandons a portion of its business that has "distinct transferable value," as defined by *Metropolitan Laundry Co. v. United States*, 100 F. Supp. 803 (N.D. Cal. 1951). In *Metropolitan Laundry*, the taxpayer was permitted an abandonment loss on a portion of a customer list that was attributable to a specific geographic area. The taxpayer had purchased the customer lists of several laundry businesses in San Francisco and Oakland. During World War II, the government seized the taxpayer's San Francisco plant for military purposes. After the war, the taxpayer had trouble reestablishing its business and abandoned its San Francisco routes while it continued its operations in Oakland.

Customer lists are closely associated with goodwill. *See Metropolitan Laundry*, 100 F. Supp. at 806. Thus, in answering the government's argument that a portion of the customer list could not be abandoned for this reason, the court in *Metropolitan Laundry* stated:

> It may be granted that good will cannot exist in the abstract, apart from a going business, and that, generally speaking, the good will of a business cannot be entirely disposed of or destroyed while the business continues. But certainly a going concern can dispose of its business in a particular area or in respect to a particular product or service along with incidental good will without abandoning its entire business. . . . So also, certain types of concerns can dispose of their business and good will apart from their physical properties ... And, in either instance, so long as the business and the good will disposed of may be assigned distinct transferrable value, the transaction may properly be recognized, for tax purposes, as a closed one. *id.* at 806-07.

The Tax Court has followed *Metropolitan Laundry* holding that "if there is a clearly identifiable and severable asset, its abandonment entitles the taxpayer to a loss deduction." *Massey-Ferguson*, 59 T.C. at 225. Specifically, *Massey-Ferguson* allowed an abandonment loss for a line of business the taxpayer had purchased from another party and operated at a distinct location, even though the taxpayer continued to manufacture similar products under a different trade name at another location.

In this case, [redacted] has not abandoned a segment of its business that is analogous to either *Metropolitan Laundry* or *Massey-Ferguson*. [redacted] has also not shown that supervisory goodwill is a "clearly identifiable and severable asset" within the meaning of *Massey-Ferguson*. Because supervisory goodwill is derived from all the assets and liabilities of the acquired savings and loan, we think it cannot be severed from them and separately abandoned.

E. Act of Abandonment

As indicated above, the intention to abandon standing alone is not sufficient to establish a recognition event; instead, there must be an affirmative act of abandonment. *See Brountas v. Commissioner*, 692 F.2d 152 (1st Cir. 1982), *cert. denied*, 462 U.S. 1106 (1983); *Beus v. Commissioner*, 261 F.2d 176, 180 (9th Cir. 1958); *Zurn v. Commissioner*, T.C. Memo. 1996-386. As a result, there is arguably an inherent requirement for an abandonment loss that the taxpayer, rather than some other party, take the action to abandon permanently the property in question. Further, an abandonment does not result simply from cessation of use. *Id. Beus*.

Thus, participation in a government program which required a taxpayer to discontinue his dairy operation, was not an abandonment where there was no showing of the irrevocable intent to abandon or never use the property again. *Strandley v. Commissioner*, 99 T.C. 259 (1992), aff'd on another issue, 73 AFTR 2d (RIA) 2118 (9th Cir. 1994). Other cases have similarly held that the actions of the government only affect the value of the property a taxpayer continues to hold. *See CRST*, 92 T.C. at 1259-61; *Beatty v. Commissioner*, 46 T.C. 835 (1966); *Consolidated Freight Lines, Inc. v. Commissioner*, 37 BTA 576 (1938), *aff'd*, 101 F.2d 813 (9th Cir. 1939).

In addition, when a taxpayer decides that it is not going to pursue an opportunity under a contract, it must act to abandon the opportunity before a deduction is allowed. *International Educational Publishing Co. v. Commissioner*, 79 F.2d 343 (3d Cir. 1935). On the other side, when the other party decides that it wishes to cancel a contract, it has been held that the recognition event occurs when the taxpayer accepts the cancellation. *George Freitas Dairy, Inc. v. United States*, 582 F.2d 500, 502 (9th Cir. 1978).

In the present case, [redacted] did not act to abandon the supervisory goodwill, even though it decreased in value when it no longer could be used toward regulatory reserve requirements. The mere diminution in value of property is not enough to establish an abandonment loss. *Kraft, Inc. v. United States*, 30 Fed. Cl. 739, 785- 86 (1994); *Lakewood Associates v. Commissioner*, 109 T.C. 450, 456 (1997), *aff'd*, 99-1 USTC paragraph 50,127 (4th Cir. 1998). See S.S. White Dental, 274 U.S. at 401. Specifically, diminution in value fails to satisfy the requirement under the regulations that a loss be "evidenced by closed and completed transactions, fixed by identifiable events." Sunset Fuel Co. v. United States, 519 F.2d 781, 783 (9th Cir. 1975). *See S.S. White Dental*, at *Id.*

F. Timing of the Loss

As set forth above, there are many reasons why [redacted] may not take a loss on the supervisory goodwill in any taxable year. However, if it is determined that a loss is allowable, the loss should have been in the year [redacted], or [redacted] at that time, lost its ability to use supervisory goodwill, i.e., [redacted] when FIRREA was enacted, rather than 5 years later.

CONCLUSION

Based on all of the above, we believe [redacted]'s claim for refund should be denied. In analyzing this issue, we reviewed the Form 5701 drafted with regard to this issue. To the extent the Form 5701 comports with the two FSAs mentioned above, we concur and approve of its issuance. For your information, however, we would like to note that it is the FHLBB and not the FSLIC that allows financial institutions to use the purchase method of accounting and to use supervisory goodwill in calculating the capital reserves.

In addition, since [redacted] did not file a claim in the *Winstar* litigation, or any other claim, the discussion pertaining to "reimbursement" should be deleted from the Form 5701.

This advice has been extensively coordinated with the Commercial Banking ISP and our National Office.

We hope this fully addresses your concerns regarding this issue. However, should you have additional questions or require further assistance, please feel free to contact the undersigned at [redacted].

[redacted]
District Counsel

By: [redacted]
Assistant District Counsel

Attachments:
As stated

cc: [redacted], Territory Manager,
Retailers, Food & Pharmaceuticals